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C O N F I D E N T I A L SECTION 01 OF 03 BUCHAREST 000237

SIPDIS

STATE FOR EUR/FO DAS GARBER, EUR/CE ASCHEIBE, EEB
TREASURY FOR JBAKER/LKOHLER

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TAGS: EFIN ECON PGOV PREL IMF EUN RO
SUBJECT: ROMANIA: IMF AGREEMENT IMPLEMENTATION POSES REAL
CHALLENGES

REF: BUCHAREST 205

Classified By: Charge d'Affaires Jeri Guthrie-Corn for reasons 1.4 (B)
and (D).

SUMMARY

¶1. (C) Romanian officials are congratulating themselves on the external financing package (reftel) concluded with the International Monetary Fund (IMF), European Commission (EC), and World Bank (WB) as "much better than we expected," according to one Ministry of Finance (MOF) interlocutor. With final approval anticipated and the first tranches of money set to flow the first week of May, Romania is already enjoying a modest market boost in response to the deal, as the leu has appreciated some four percent against the euro in the last week. The exuberance may be short-lived, however, with implementation of the package's provisions looming as a substantial political challenge in this presidential election year. Full implementation will require not only cuts in spending, but big changes in how the Government of Romania (GOR) conducts its fiscal business. Package skeptics, particularly in the Social Democratic Party (PSD), have lots of room to create roadblocks should they so choose, since some PSD-controlled ministries--especially the Ministry of Labor--are key to making the provisions work. End summary.

LENDING TERMS: A "PLEASANT SURPRISE"

¶2. (C) While the contents of Romania's official letters of intent to the IMF, EC, and WB have not yet been made public pending official approval, several contacts told post's EconCoun in recent meetings that the lenders agreed to less stringent fiscal conditionalities and were much more accommodating of Romania's concerns than the GOR was expecting. MOF Director of Macroeconomic Analysis and Policies Dorin Mantescu said Romania had the benefit of getting in line after IMF-led rescues of Hungary and Latvia, with the IMF and EC sharing perceptions that those deals had been too severe and had contributed to political and social instability. Mantescu believes GOR leaders got "good credit points" for reversing their prior political "no IMF" pronouncements and proactively seeking a deal before worsening conditions forced their hand. WB Senior Economist Catalin Pauna agreed, saying in addition that EC negotiators seemed especially keen to avoid perceptions that Brussels was demanding tough fiscal measures of Romania at a time when budget red ink is flowing in many EU member states, including some of the biggest. The EC representatives "seemed to feel guilty about asking Romania to do anything really hard" and exerted a moderating influence on the IMF in the talks, Pauna observed.

¶3. (C) Under the deal, the IMF will loan 12.95 billion euros at 3.5 percent interest to the National Bank of Romania (BNR) to add to reserves, with the understanding that BNR will use it to support the leu and to reduce bank minimum reserve requirements. The first tranche of up to six billion euros should be released as soon as the IMF Board approves the deal on/around May 5. (Note: BNR has already announced that, as soon as the IMF tranche is received, it will drop the reserve requirement from 40 percent to zero for foreign currency-denominated liabilities with maturities of over two years, thereby freeing up some 800 million euros in new liquidity.) Five billion euros from the EC and one billion from the WB will go to MOF to support GOR deficit spending. The European Bank for Reconstruction and Development (EBRD) and European Investment Bank (EIB) have pledged an additional one billion euros in lending for specific projects to be determined later. IMF-led teams will conduct quarterly monitoring visits.

¶4. (C) The agreement allows Romania to run a fiscal deficit of up to 4.7 percent of GDP in 2009 and in excess of three percent in 2010. The IMF is also requiring the GOR to adjust its 2009 revenue and spending projections to conform to the IMF's (admittedly very pessimistic) minus 4.0 GDP growth projection. According to BNR Chief Economist Valentin Lazea, that scenario would produce a deficit of 5.8 percent of GDP without an IMF program, meaning that the GOR must trim spending by 1.1 percent of GDP, or more than two billion euros, to stay within the 4.7 percent target. EC and WB funding will cover about half of the allowed deficit, Lazea



believes, with MOF left to finance the other half itself by continuing to auction T-bills in the local market. Lazea observed that BNR's reduction in reserve requirements may not lead to much new lending by banks, since a good part of the money may simply go to buy T-bills to finance the deficit*and nothing will prevent banks from repatriating some of the capital if they choose, despite verbal assurances to the contrary. Still, if the economy performs better than minus 4.0 percent (and both MOF and BNR seem convinced that it will), the required fiscal adjustment may be smaller.

AND NOW COMES THE TRICKY PART...

¶5. (C) The GOR won't have to cut spending as radically as it feared going into these negotiations, and the package requires no major increases in VAT rates or the flat tax on income. Even so, the required cuts won't be painless. The GOR is already moving to impose wage and hiring freezes across government ministries and will attempt to enforce reductions in public sector bonuses (which often represent a big chunk of annual pay for low-salaried workers) as well as cuts in transportation subsidies for government employees and suspension of "holiday tickets" for free visits to GOR-owned spas and other resorts. Government procurements of big-ticket items like cars and furniture will be blocked for the rest of the year, and new excise taxes on luxury goods, tobacco, and alcohol will be imposed. For the time being it appears the GOR will avoid having to resort to substantial layoffs, but public sector unions are still hopping mad. Their ability to hit back through work stoppages hasn't been fully tested: they have staged a series of small protests, but no crippling strikes big enough to really hurt so far.

¶6. (C) All post's interlocutors agree that these stopgap measures will ultimately not be enough, and it is the IMF conditionalities for larger structural reform which will pose the biggest political challenges for the GOR. These reforms focus on public sector wages and pensions, precisely because they are a major source of the explosion in GOR deficits in
¶2008. BNR's Lazea explained that several successive years of double-digit wage hikes for government employees, along with last year's increase of more than 20 percent in "Pillar 1" (i.e. fully state-funded) pensions, would produce an annual

deficit of more than two percent of GDP even if all other revenues and spending were in balance. There are currently 4.8 million workers contributing to Pillar 1 and 4.6 million pensioners drawing from it, a demographic time bomb which is clearly unsustainable, Lazea said.

¶7. (C) To begin to address the problem the GOR has already implemented at IMF urging a 3.3 percent hike in social security contributions for workers and employers, and froze GOR contributions to Pillar 2 (private) pension funds at 2008 levels despite howls of protest from international fund managers (including U.S. firm AIG) that this is a violation of the law which partially privatized social security. Normally the IMF would frown on such blatant reneging on funding commitments, but had acquiesced in this move due to the system's dire funding problems, Lazea said. In addition, the GOR will begin indexing pensions to inflation rather than to the average wage, meaning much smaller percentage increases in the COLA in future years. The IMF will require the GOR to accelerate its schedule for extending the minimum retirement age, so that it reaches age 65 by 2011 instead of 2013, and the GOR must extend social security payroll deductions to the Romanian military and police, which until now were exempted. These steps will allow the GOR to muddle through for a while, but much bigger hikes in social security taxes or a rollback in benefits will eventually be required, Lazea insisted. The "newer, nicer" IMF won't require such politically poisonous steps this year but could push harder on pension reform in 2010, Lazea believes.

¶8. (C) According to the World Bank's Pauna, the centerpieces of structural reform under the IMF package are multi-year budgeting and public sector wage reform, two areas in which WB technical assistance will be crucial. The first aim is for the GOR to craft and pass legislation putting in place a system for long-term budget planning and multi-year appropriations for major expenditures, thus ending the practice of frequent "budget rectifications" throughout the year. The second goal is establishment of a unified pay and benefits system extending across the GOR, eliminating the



current hodgepodge in which every ministry or agency sets its own pay scales and determines its own bonuses for workers. This will require a "vast untangling" of hundreds of separate laws, executive orders, and other regulations and will require several years to implement, Pauna said, but the IMF/EC/WB are expecting Romania to demonstrate some initial progress in terms of legislative action by the end of 2009.

COMMENT

¶9. (C) All our interlocutors agree that the reforms stipulated under the IMF program are badly needed to put Romania on a path toward sustainable fiscal health. However, they equally agree that Romania's previous track record (several IMF accords, but none fully completed and implemented since 1990) is not especially encouraging. Lazea of BNR openly questioned whether a more accommodating IMF could really get Romania to conduct major surgery on such sacred cows as pensions and public sector compensation when the "old, bad" IMF could not. The GOR must take some initial steps, including legislative action, on certain items before the end of this year, but the Parliament will likely be taking up such legislation in the midst of the fall presidential election campaign, making for a combustible political atmosphere. There are plenty of opportunities for IMF program skeptics to throw a wrench into the works; Catalin Pauna said he is especially worried about the PSD-controlled Ministry of Labor, which could easily derail government pay reform simply through "selective inertia". Romania has prided itself on being a reliable NATO partner and responsible new EU member; it now has the opportunity to demonstrate whether that reliability extends to matters of money. A lot is riding on the answer. End comment.
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